SMALL COUNTRIES: RECIPES FOR ECONOMIC SUCCESS

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ABSTRACT

When looking at the world map it is obvious that there is a great variation in size among sovereign countries. However, the variable country size does not play a major role in many branches of economics. Mostly and especially in public economics, we have a middle-sized country in mind when we try to arrive at general arguments about reform and change. This neglects the possible economic impact of country size. Of course, international economics cares about country size in distinguishing between countries, e.g., those able to influence world prices, and those that cannot. The latter are generally considered to be of lesser significance, at least in terms of this variable. Most economists would however agree that we rarely analyze the economic impact of size. What do we learn from looking more carefully at the economics of small nations? The article, based upon a speech delivered by the author, addresses this question and others related to the topic.

INTRODUCTION

Why is it that we rarely addres the issue of the economic impact of size of nations? One reason for this is straightforward. Standard economic theory has already dealt with this subject in the 1950s and 1960s, and there is little left to say about it from this view. We will go into the details of the arguments in a minute, but let me summarize the theoretic predictions. Smaller countries should have a clear cost disadvantage in the private sector as well as in the public sector compared to larger countries. From this view, a general inferiority of smaller countries and especially very small countries has been inferred. Consequently, economic chances of survival and prosperity for very small nations in the middle of the 20th century was questioned.

Since then, numerous new sovereign countries have been formed by the end of the colonial rule, the split up of nations and secessions from existing countries. There are currently 194 countries in the world of which 54 have less than 2 million inhabitants. Astonishingly, 34 countries have less than 500,000 residents. The dynamics of the process are even more impressive. In 1914 there were only 62 sovereign states on the entire globe; at the end of the Second World War the number increased to 74. Thus, within a hundred years the number of independent countries has more than tripled, a development which has surely not reached its limits yet. There are separation movements almost everywhere in the world, e.g., Scotland, Kosovo, Quebec, Chechnya. East Timor, another result of a secession, is the youngest member of the international family.

What is striking is the impression that – despite theoretic predictions from standard economics – some of the smaller countries are quite wealthy. Especially some very small countries such as Liechtenstein and Luxembourg belong to those countries in the world with the highest per capita GDP. At a first glance one might conclude that the negative relationship between country size and national welfare measured in per capita GDP is inexistent.

In this article I will first review some of the arguments that led to derive a theoretic inferiority result for smaller countries from a cost or production oriented view. We then take a short look at the empirical results concerning the connection between country size and wealth. After that, the focus of my article will be on those factors, which make small countries economically successful.

THEORETIC ARGUMENTS

The main understanding of economists concerning the connection of country size and welfare dates back to a conference in the 1950s. Major contributions of that conference have been published in 1960 by Robinson under the title, "The Economic Consequences of the Size of Nations." The articles collected in this volume remain the principal substantive contribution to the theoretic analysis of the connection between country size and wealth.

Obviously, a huge list of disadvantages arises from standard economic theories. Most of them consider size disadvantages of the private sector.

First, a small domestic market leads to diseconomies of scale in private production. Hence, economies of scale advantages, which play an important role in differentiated product markets, cannot be exploited. A similar argument concerning minimum efficient scales can be applied to research, development and the technology sector. In these sectors small countries should therefore be put to a disadvantage.

Second, small countries suffer from less competition within internal markets, which may lead to an inefficient allocation.

Third, some arguments touch upon the possibilities of strategic trade policy. The idea was introduced to international economics among others by Krugman, for instance in his book with Helpman, "Market Structure and Foreign Trade." One of the arguments is that the home market is not large enough to back export strategies. Assuming economies of scale and learning curves in production, small countries do not have the chance to prepare firms on the domestic market to enter the world market. There are also limited possibilities of import-substitution, but that may not be a disadvantage.

Forth, small countries are more vulnerable than larger countries in several ways. They are highly dependent on imports and exports. Their exports are geographically specialized, which means that exogenous economic shocks to the export region may hurt small countries stronger than larger ones. Furthermore, their internal balancing mechanisms for economic shocks are rather limited. In a similar vein they may be more prone to natural hazards, because in small countries often a considerable part of the country is affected by natural hazards. Many smaller countries have a poor domestic resource base and normally a narrow range of domestic output, which also makes them quite vulnerable to exogenous shocks.

Fifth, small countries are internationally ‘neglected’ to a certain extent, which may mean that they have little power to pursue economic interests internationally.

Sixth, when we consider the public sector, smallness is also a cost disadvantage. Per capita costs of non-rival public good production, and hence taxes, decrease with an increasing number of citizens. This is due to the simple fact that in a large country costs necessary to provide public goods can be distributed among a larger number of tax payers.

Of course, there are a few obvious objections against these arguments. Globalization and trade openness decreases the negative size effect, and non-rival public good do not occur in reality like theory suggests. However, the negative size effect associated with diseconomies of scale has been shown to be empirically relevant for the production of private as well as for public goods.

What seems to be a more serious criticism is that most of the arguments dwell upon the cost or production side and not on the demand side. People in small countries might face less bureaucratic problems, their preferences might be more closely followed in the public good provision process and law-making authority may be a high value for itself. Before we go into the details of these and related arguments let me first take a look at the empirics.

EMPIRICAL CONSIDERATIONS: COUNTRY SIZE AND WELFARE

It is straightforward that there are a lot of factors, which play a role in influencing a country's welfare. One might conjecture that the following factors may affect growth and welfare or the living standard of a country: the endowment in terms of natural resources, its climate and its disaster proneness, the growth and demographical composition of its population, its important institutions, its geographic location, its laws, its religious and ethnic background, its ethnic and linguistic fractionalization, its knowledge base, its political system, its relationship to adjacent countries, to name but a few. For the purpose at hand we are especially interested in the impact of country size on welfare. Though, we know that so many diverse factors affect the economic well-being of different countries that it is extremely difficult to isolate the factor of size.

We may recall that theory predicts that smaller countries should *ceteris paribus* be less wealthy, because they have to bear economic disadvantages. To test for this hypothesis, we consider a set of independent variables that are commonly assumed to influence welfare. Technically, we have run several multiple regression models. Our proxy for country welfare is per capita GDP, and we use the number of inhabitants as a proxy for country size. All the results are quite robust with regard to the inclusion or exclusion of single variables or with regard to how we measure single variables.

In none of our models the number of inhabitants plays a role in determining a country's welfare. The according coefficients are always far from being significant; however all other variables display expected signs and are significant in most of the models. Our results provide a strong case in favor of the hypothesis that there is absolutely no connection between country size and wealth. This latter conjecture is in opposition to all the arguments presented before and constitutes a notable result.

We even observe a negative correlation between country size and per capita GDP, which means that larger countries have lower levels of welfare, but the correlation coefficient is not significant. Anyway, given these results we feel to be on the safe side in concluding that a clear connection between country size and country welfare, in the sense that smaller countries have lower welfare levels, is rather improbable.

A natural question arises from these empirical results. Which factors make small countries successful? We know for instance from a study of Kocher, titled "Very Small Countries: Economic Success against All Odds," that small countries actually have to bear some non-negligible costs of small size in the private as well as in the public sector. This fact is perfectly in line with the predictions of standard economic theory. Hence, there have to be some important factors on the demand side, which determine a small country's success and which have been neglected so far. It is a matter of fact that economic theory has largely remained silent on this issue. This is most likely due to the fact that a quantitative assessment of the arising questions is difficult or impossible. In the remainder of my article I nevertheless try to give some hints of possible sources that are able to level out the negative size effect on the cost side.

HOW CAN SMALL COUNTRIES BE ECONOMICALLY SUCCESSFUL?

As mentioned before, there are various factors that co-determine a country's welfare and every country has its peculiar conditions. So, where to start when asking the question of factors that make a country economically successful? One approach that we employ is to take a closer look at those countries, which are especially hurt by the negative effect of size. In these countries one can study how they cope with the consequences of smallness. Hence, we take a closer look on very small countries in the world, but have a general assessment in mind. Very small countries are the object of research, simply because the negative effects as well as the positive effects should be most visible there. Bear however in mind that we are heading for general results that are also applicable to small countries such as Belgium, Finland, Switzerland, or Austria and Taiwan.

We start by quickly going through some advantages that are sometimes ascribed to small or very small countries before assessing them in greater detail.

First, small countries generally have greater social homogeneity, cohesion and coherence, which results in lower costs of social heterogeneity. Small countries are also supposed to have less ethnic and linguistic fractionalization. I will however show in a minute that this is actually not the case.

Second, as a consequence of being internationally neglected, very small countries are able to create and protect narrow niche markets. This status of international negligibility leads to an increase in the efficiency of national law-making authority and is sometimes referred to as a benefit of sovereignty. Thus, smaller countries can create and protect legal differences with economic impact between them and adjacent countries more easily.

Third, the disadvantage in the public sector – recall the diseconomies of scale in the production of public goods – forces very small countries to source out part of the public good production and provision process. This may in turn increase efficiency in the public sector, which has forcefully been shown by Gantner and Eibl in a study titled "Public Good Provision in Small Countries. The Example of Liechtenstein."

Forth, small countries are supposed to have a smaller ‘distance’ between politicians or bureaucrats and the citizenship, where the term distance may be understood in several ways.

Fifth, generally, small countries have to bear lower congestion costs, because they tend to have fewer agglomerations and conurbations.

Sixth, small countries are said to be more flexible in decision making, political decision making appears to be more efficient and the electorate is said to have a greater openness to change.

In the following section I want to look at some of these arguments more closely.

SOCIAL HOMOGENEITY VERSUS FRACTIONALIZATION

Contrary to our expectations and contrary to arguments raised in many studies, social homogeneity does not seem to be an important factor for success of small countries. In a sample of 21 very small countries the ethnic, linguistic and religious fractionalization is sometimes relatively high. It might simply be the case that it is unimportant or more or less unimportant in economic terms to have a homogeneous population with regard to ethnicity and language. A successful small country is almost forced to be international due to its high dependency on export and imports and due to the lack of possibilities at home, especially in education. Moreover, very small countries are often dependent on workers from abroad, like, e.g., Liechtenstein. It is therefore not correct to speak of a small country population homogeneity as one of the major advantages. On the contrary, in most cases its international orientation and its heterogeneity seem to be factors of success. Unfortunately, we can say nothing about the identification of citizens with their small countries, because comparative data on this issue do not exist. A possibly strong identification might play an important role in the perception of ‘homogeneity’.

INTERNATIONAL NEGLIGIBILITY AND LAW-MAKING AUTHORITY

Law-making authority has been shown to be crucial for small countries and for very small countries. It can simply be viewed as a territorial monopoly in passing and enforcing laws. Recent studies, for instance, prove that small countries and small highly autonomous regions in Europe have significantly better macroeconomic data than adjacent regions of larger countries. In a sense, small countries exert their law-making authority to occupy economic niches that are prone to boost economic growth. A necessary condition for running this strategy is the fact that the according country is international negligible. Otherwise countries that are negatively affected by these strategies would put more effort in preventing small countries of pursuing the strategies.

As to very small countries, which should again be viewed as examples for a more general result there are three main sources of welfare: natural resources, tourism and financial services. The case where national resources determine welfare in small countries is however rather rare.

We may note further that the common stereotype that very small countries are mostly tax havens is not fully valid. Of course, some of the wealthiest very small countries – like Liechtenstein and Luxembourg – rely on financial services as a major source of income. Their economic structure however is not much different from the average OECD economy, when one, for instance, compares the distribution of workforce among the three main sectors. We take this as evidence that a highly specialized economic niche strategy in a small country may – or even should – lead to a diversified economy. Ultimately, very small countries are not very much different from the economy of a wealthy region in a larger country. Of course, the niche strategy does still play an important role in such a 'developed' small country, but its impact is often exaggerated.

Another nice facet that proves the small country's preference for negligibility is the fact that no high-income very small country is part of the well-known and politically important OECD list concerning money laundering. Appearance on such a black list would negatively interfere with protecting one's own economic niche and is therefore prevented by the wealthy small countries. Indeed, Liechtenstein for instance, devoted quite some effort to get removed from this list, after being enlisted originally. Most of the very small countries are however enlisted in the less problematic OECD list of harmful tax practices.

Contrary to the exploitation of natural resources and to tourism – which both do not require a great degree of autonomy – law-making authority and a considerable scope of sovereign action are prerequisites for a specialization in financial services. Hence, the promotion of the financial services sector seems to concern the kernel of relevant sovereignty for small countries. Judging from a comparison of fully sovereign very small countries and autonomous regions of larger country with limited sovereignty we can assess the question in greater detail. It might be concluded that a rather limited portion of full 'effective' sovereignty is sufficient to ensure the pursuit of niche strategies in economics. This result is independent of a territory's political sovereignty, international recognition or its membership in international and regional organizations. It heavily depends however on a high level of trade openness and on geographic factors. I will have to say a few words on the latter factors in a minute.

A last question in connection with niche strategies of small countries concerns the reaction of larger countries. We already mentioned that the impact of the small countries' policies should be negligible in most cases, but the last years have shown that this is not always the case. It is therefore astonishing that the tax policies of certain small countries have not been tackled seriously. Possible problems with the modification of international treaties are only one explanation for this phenomenon, because there are always ways to challenge adverse practices. Think, for instance, of the endless discussions and retaliation policies between the EU and the USA in the WTO framework, when certain protectionist measures or 'unfair' subventions are at stake.

Beside the negligibility argument, which has some appeal but also obvious limits, a second argument has some explanatory power. Influential groups in larger countries may have an incentive to maintain loopholes in international treaties and regulations, which allow small countries to pursue niche strategies. There might be several interest groups that have an advantage from this status quo. From a public choice point of view, (tax) competition between larger countries and small countries limits the effects of the territorial monopoly that one's own country can exert. In an environment of capital flow liberalization, the existence of tax havens clearly limits the scope of action of a Leviathan government in a larger country. Protecting the according countries therefore is a kind of self-protection against the monopoly power of one's own government. Federalists, liberals, enterprises, rich individuals, advocates of subsidiarity and the according lobbies might have an interest in protecting the law-making authority of very small countries. Employing this strategy they are able to constrain their own countries' policy options. It is questionable if economic niche strategies of very small countries would be possible without external support.

The benefits of sovereignty do, hence, not depend on country size, but negligibility makes it much easier to pursue economic niche strategies. In principle, however, larger countries would be able to follow similar strategies. Though, they would have to face serious opposition form other countries. Negligibility therefore is a necessary, but not a sufficient condition.

INTERNATIONAL OUTSOURCING IN THE PUBLIC SECTOR

As mentioned above, economic theory predicts that relative public expenditure should decrease with an increasing number of inhabitants, because of the nature of non-rival public goods. It has been shown that there is indeed a significant negative relationship between the number of inhabitants and public expenditure as a percent of GDP. The effect is however not huge, although it seems to have increased over the last three or four decades. In a thorough case study we could show, how small countries are able to keep the costs of public good production and provision low.

First, they tend simply not to provide those public goods that have the highest diseconomies of scale if that is an option. Take for instance Costa Rica, which has – as many other smaller countries – no military force. Most of the countries, which decide not to provide single public goods, try to find – mostly adjacent – countries that provide the according good. Typical cases for this strategy that Gantner and Eibl labeled 'international outsourcing' are external security and monetary policy. Interestingly, our study of the according arrangements showed that they often are mutually beneficial and they have much lower costs than the self-provision option for the small countries.

Second, to much greater extent than theory suggests it seems to be possible to tailor public goods to the need of very small countries and make their provision affordable. It is noteworthy that citizens of very small and small countries, as far as we are aware of, do not take these tailoring of public goods as a weakness or as something that restricts their sovereignty. There are no indications that they are less confident with the public goods provided than citizens of larger countries.

A last point to be made is that the administration in high-income very small countries has a much higher propensity to source out parts of the public good provision and production process than larger countries. This result is not contingent on the class of public goods – only some highly visible signs of sovereignty seem to be excluded – and on the outsourcing partner, whether it is a private firm or a foreign public agency. The smaller a country is, the more it can profit from cross-border outsourcing of public good provision, for instance in the health sector and in education. Given the fact that outsourcing is the more efficient alternative compared to in-house production in the majority of cases, this strategy is beneficial to small countries.

TRADE OPENNESS AND ECONOMIC INTEGRATION

It is not difficult to show that trade openness is a prerequisite for economic success of small countries. It allows leveling out the diseconomies of scale effect in private production to a certain extent. When we furthermore assume a preference for variety in consumption à la Dixit and Stiglitz or Krugman, then the narrow base of goods produced nationally would lead to lower utility levels without trade openness. In this sense trade openness and economic integration is viable for small countries, and they have always put a lot of effort in achieving world market access and preferential treatment.

Contrary to that, we cannot be sure about the effects of membership in regional trading arrangements or regional integration areas. Note at this point that very small countries differ significantly from small countries. It is very important for the economic success of small countries to be part of regional integration areas – a fact that all studies on European Union accession overwhelmingly show. However, our conclusions cannot be equally deterministic when we take a look at very small countries. The reason for this asymmetry is that the latter have to protect their economic niche strategies. Too high degrees of trade openness in those areas, where their niches are situated, might be harmful. As mentioned before, many high-income very small countries rely to a certain extent on financial services, where the trade off between openness and protection is less severe. It is obvious that the more open financial markets worldwide are and the more unrestricted capital flows are, the better niches are protected.

It is quite interesting to see that most of the very small countries seem to follow expected strategies. They are not member of regional integration areas, but often have preferential access to the markets of the area or even form a customs union with the area. Nevertheless, critical branches of the very small country’s economy are exempted from the arrangements, like it is often the case for the agricultural sector. A good example is Iceland, where natural resources are the main source of wealth and one of the major arguments not to join the European Union, because EU rules would interfere very much with the Icelandic fishery sector.

OTHER ARGUMENTS

There is little general empirical evidence on the effects of the smaller ‘distances’ in small countries. We take the accessibility of politics and bureaucracy as one measure of distance. In a sense, a comparison to larger countries is not straightforward, because the federal structure of large countries should play an important role in determining actual distances. Note that not too many small countries have a federal structure. We are not aware of any study on this issue. The effects of a more direct access to the administration and to politics therefore remain unclear.

Likewise, we cannot draw final conclusions on the effects of political systems of smaller countries. We are sure that more general results – for instance, the superiority of democracy over other forms of political systems – hold also for smaller countries. However, political structures differ very much across countries and a clear connection between political systems and economic success – that would be special for small countries – does not seem to exist.

CONCLUSION

Contrary to the theoretic predictions for the private as well as the public sectors small countries do not have lower welfare levels. Our empirical results suggest that there is no connection between country size and welfare, which is a noteworthy point. In a second step we were interested in the factors that drive the economic success of small countries. A better understanding was achieved by doing thorough case studies of very small countries, which served as kind of extreme examples where the effects should be most visible. We can show that there are some determinants of success that are especially important for small countries. Among those are the beneficial effects of law-making authority, international outsourcing and openness. Other often-stated factors do not seem to be so important, like social homogeneity. One should however bear in mind that our results cannot be applied to every small country as a general rule. Country-specific factors have been shown to be consequential, but our results may serve as a general guideline for decisions in economic policy.

From the viewpoint of economic theory I would like to stress the following points. The concentration of standard economics on the cost or production side, when analyzing small countries, is misleading. Indeed, small countries bear a cost disadvantage, but advantages of smallness may even be greater than the disadvantages. Hence, an analysis restricted to the production side is inadequate to assess the economics of small countries. As a consequence, I believe that further economic tools and theories that concentrate on the demand side effects still have to be developed in order to answer some of the arising issues

Finally, what can we conclude from our results for medium-sized countries like Taiwan or Austria? To a certain extent larger countries can also pursue niche strategies, but they have fewer degrees of freedom than small countries. Nevertheless there are some examples, where Austria has beneficial legislative differences to its much larger neighbor Germany, for instance in the taxation of private foundations. I am sure that there are similar cases for Taiwan and China. Also some other findings can analogously be applied to larger countries. International outsourcing in the public sector is a concept that is also important for larger countries. It often implicitly appears in the discussion on the task assignment to the European, the federal and the state level in Austria. A further lesson that larger countries or regions of larger countries can learn from very small countries is that cross-border cooperation can have very beneficial effects. Adaptable examples from very small countries would be education, health issues and research, where a division of labor among countries might be fruitful.

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ACKNOWLEDGEMENT

This article is based upon a speech given at the "Joint Conference on "Public Affairs in Global Perspective: Taiwan and Austrian Experience," Innsbruck, June 25, 2002. I am thankful for cooperation with Martin Kocher in preparing the speech draft. The reported empirical evidence rests largely on his doctoral thesis and forthcoming book, "Very Small Countries: Economic Success Against All Odds."

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